Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]TL-N-~~4993-98~~
[redacted]

date: 3/18/99

to: [redacted]
Large Case Manager

from: Associate District Counsel
Southern California District Counsel

subject: [redacted] (fka [redacted])
EIN: [redacted]
Tax period: [redacted]

This is in response to your request for advice regarding the assertion of the I.R.C. § 6662 accuracy-related penalty with respect to the taxpayer's failure to report a gain from the sale of stock in a controlled foreign corporation to a corporation owned by a related party.

DISCLOSURE LIMITATIONS

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to the attorney-client and deliberative process privileges and, if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to persons beyond those specifically indicated in this statement or to taxpayers or their representatives.

This advice is not binding on the Internal Revenue Service and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether it is appropriate to assert the I.R.C. § 6662(b)(1) penalty for negligence or disregard of rules or regulations with respect to the taxpayer's failure to properly report the sale of stock to a related party?

2. Whether the disclosure of the transaction on Form 5471 is an adequate disclosure under I.R.C. § 6662(d)(2)(B) negating the applicability of the § 6662(b)(2) penalty for substantial understatement of income tax?

CONCLUSIONS

1. Yes.

2. No.

FACTS

This advice is contingent upon the accuracy of the facts recited below. These facts were obtained from (1) the draft Explanation of Items, Form 886-A, (2) Schedule O, Form 5471, and (3) the report of IRS Valuation Specialist [redacted]. If the facts recited do not comport with your understanding of the transaction or if additional information that is inconsistent with these facts is obtained, you should not rely on this memorandum but should seek further advice from this office.

During all relevant periods [redacted], now known as [redacted], ("[redacted]") was owned by [redacted]. In [redacted], [redacted] purchased a [redacted] percent interest in [redacted], a controlled foreign corporation, from the former [redacted] for $[redacted].

In [redacted], [redacted] sold approximately [redacted] percent of [redacted]'s stock to [redacted] ("[redacted]"). [redacted] is owned by [redacted]'s son, [redacted]. [redacted]'s tax department has represented that [redacted] did not realize any gain on the transaction because the sales price of approximately $[redacted] was purportedly equal to [redacted]'s basis in the [redacted] stock.

[redacted] did not obtain an appraisal or other determination of the fair market value of the [redacted] stock transferred to [redacted] at the time of the sale. As of this date, [redacted] has not provided any information establishing the fair market value of the [redacted] stock when it was transferred to [redacted]. Without regard to minority interest and liquidity discounts, a $[redacted] price for a [redacted] percent interest in [redacted] equates to an overall value of less than $[redacted] for [redacted] percent of [redacted]'s stock.

[redacted] did not report the sale of [redacted] stock on Schedule D of its [redacted] U.S. Corporation Income Tax Return, Form 1120. However, [redacted] did report the transfer of [redacted] stock on Form 5471 attached to the return. On Form 5471, Schedule O, the taxpayer disclosed the date of the sale, to whom the sale was made, the volume of equity sold and an "amount received" in dollars. The Form 5471 does not contain a designated place to indicate the basis of the equity sold and none was indicated therein.

[redacted] reported taxable income of $[redacted] on its [redacted] income tax return.

During the opening conference for the [redacted] and [redacted] examination, [redacted] was offered an opportunity to disclose items under Rev. Proc. 94-69, 1994-2 C.B. 804. The taxpayer made no disclosure pertaining to the item at issue.

An IRS Valuation Specialist has determined that the value of 100 percent of [redacted]'s stock was approximately $[redacted] as of the date of the sale to [redacted]. After applying minority interest and liquidity discounts the Valuation Specilist concluded the value of the shares transferred to [redacted] was approximately $[redacted]. For purposes of this advice, we have assumed that this valuation is reasonably proper and accurate. We are not opining on the propriety or accuracy of the valuation.

You have indicated your intention to assert the I.R.C. § 6662 penalty because the taxpayer was negligent in failing to report the sale of [redacted] stock to [redacted] and/or because the [redacted] failed to report a $[redacted] gain on the sale resulting in a substantial understatement of its income tax liability.

DISCUSSION

I.R.C. § 6662 provides, in certain cases, that there shall be added to the tax an amount equal to 20 percent of the portion of any underpayment of tax required to be shown on a return. The section 6662 penalty applies to the portion of any underpayment which is attributable to (1) negligence or disregard of rules or regulations or (2) any substantial understatement of income tax. I.R.C. § 6662(b)(1) and (2).

The term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws, and the term "disregard" includes any careless, reckless, or intentional disregard. I.R.C. § 6662(c). In the case of a corporation, a substantial understatement of income tax is an understatement which exceeds the greater of 10 percent of the tax required to be shown on a return or $10,000. I.R.C. § 6662(d). In certain cases the amount of understatement is reduced by the portion of the understatement attributable to:

> (i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or
>
> (ii) any item if:
>
> (I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and
>
> (II) there is a reasonable basis for the tax treatment of such item by the taxpayer.

I.R.C. § 6662(d)(2)(B).

I.R.C. § 6664(c)(1) provides a reasonable cause exception to the imposition of the section 6662 penalty "with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion."

1. <u>Was [redacted] negligent for purposes of I.R.C. § 6662(b)(1)?</u>

The amount realized from the sale or other disposition of property shall be the sum of any money plus the fair market value of the property (other than money) received. I.R.C. § 1001(b). [redacted] apparently made no attempt to ascertain and report the fair market value of [redacted] equity as the amount received therefor in its return. Consequently, [redacted] failed to report approximately $[redacted] out of the approximately $[redacted] of sales proceeds it constructively received and reported no gain instead of the approximately $[redacted] gain that results from properly viewing the substance of the transaction.

In short, the [redacted] made no attempt to comply. [redacted]'s conduct falls squarely within the I.R.C. § 6662(c) description of negligence as "failure to make a reasonable attempt to comply with the Code."

If taxpayer conduct is negligent for purposes of I.R.C. § 6662(b)(1), then the I.R.C. § 6662 penalty will apply unless the reasonable cause exception of I.R.C. § 6664(c) is applicable. I.R.C. § 6664(c) provides two prongs that must be met. First, there must have been reasonable cause for the portion of the underpayment in question. Second, [redacted] must have acted in good faith with respect to such portion.

No reasonable cause exception is applicable here. Treas. Reg. § 1.6664-4(b) provides in part as follows.

> The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. . . . Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. . . . Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of the property. Other factors to consider include the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used. . . .

There was no reasonable cause for [redacted]'s conduct. [redacted] made no effort to assess the proper tax liability. [redacted] did not even obtain an appraisal, much less obtain an appraisal that would meet the above description of an adequate appraisal.

Further, [redacted] has offered no evidence to establish that it could meet the second prong of the I.R.C. § 6664(c) exception. That is, [redacted] has offered no evidence that it acted in good faith with respect to its tax treatment of the transaction.

2. a. <u>The disclosure of the transaction in the Form 5471 will not serve as a disclosure adequate to allow [redacted] to escape the I.R.C. § 6662 penalty for a substantial understatement for purposes of I.R.C. § 6662(b)(2).</u>

The adequate disclosure exception of I.R.C. § 6662(d)(2)(B)(ii) provides two prongs that must be met. First, there must be adequate disclosure of the item. Second, there must be a reasonable basis for the tax treatment of the item.

[redacted] has offered no evidence or argument to establish that its tax treatment of the transaction in question was reasonable. The legislative history of P.L. 103-66 (Omnibus Budget Reconciliation Act of 1993) makes clear that the "reasonable basis" standard is a high standard. The Senate Committee Report states in part as follows:

Under the bill, the "reasonable basis" standard replaces the "not frivolous" standard for purposes of the accuracy-related . . . penalt[y]. The committee intends that "reasonable basis" be a relatively high standard of tax reporting, that is, significantly higher than "not patently improper." This standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim.

The Conference Agreement states in part as follows.

The conference agreement follows the Senate amendment. The conferees intend that "reasonable basis" be a relatively high standard of tax reporting, that is, significantly higher than "not patently improper." This standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim.

"Reasonable basis" has not yet been defined in the I.R.C. § 6662 regulations. However, the regulations provide that "[t]he reasonable basis standard is significantly higher than the not frivolous standard applicable to preparers under section 6694 and defined in § 1.6694-c(c)(2). Treas. Reg. § 1.6662-3(b)(3); Treas. Reg. § 1.6662-7(c).

Thus, the adequate disclosure exception does not apply because [redacted] has not established that it had a reasonable basis for its tax treatment of the transaction at issue.

Even if [redacted] could establish that it had a reasonable basis for its tax treatment of the transaction at issue, the adequate disclosure exception would not apply because what minimal disclosure [redacted] made did not meet the applicable disclosure strictures.

Treas. Reg. § 1.6662-4(f) *Method of making adequate disclosure* provides in part as follows.

(1) *Disclosure statement.* Disclosure is adequate with respect to an item . . . or a position on a return if the disclosure is made on a properly completed form attached to the return or to a qualified amended return (as defined in § 1.6664-2(c)(3)) for the taxable year. In the case of an item or position other than one that is contrary to a regulation, disclosure must be made on Form 8275 (Disclosure Statement) . . . .

(2) *Disclosure on return.* The Commissioner may by annual revenue procedure (or otherwise) prescribe the circumstances under which disclosure of information on a

return (or qualified amended return) in accordance with applicable forms and instructions is adequate. If the revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275-R, as appropriate, attached to the return for the year or to a qualified amended return.

[redacted] did not disclose the item at issue on a Form 8275. Rev. Proc. 94-74, 1994-2 C.B. 823, is the annual revenue procedure described in Treas. Reg. § 1.6662-4(f)(2) applicable in the instant case. This revenue procedure does not prescribe that an item such as the one at issue can be disclosed on a return. Rev. Proc. 94-69, 1994-2 C.B. 804, provides special procedures for CEP taxpayers to make adequate disclosure with respect to an item. Rev. Proc. 94-69 affords [redacted] no relief from the I.R.C. § 6662 penalty in the instant case.

Finally, the adequate disclosure exception may not apply in any event because [redacted] did not properly substantiate the transaction. Treas. Reg. § 1.6662-4(e)(2)(iii).

b. <u>The I.R.C. § 6662 penalty for a substantial understatement for purposes of I.R.C. § 6662(b)(2) will apply.</u>

There is no substantial authority for at best recklessly failing to report $[redacted] out of $[redacted] of constructively received sales proceeds. As explained in section 2.a, the disclosure on the Form 5471 was not adequate to allow [redacted] to escape the I.R.C. § 6662(b)(2) penalty. As explained in section 1., the reasonable cause exception of I.R.C. § 6664(c) does not apply. Thus, the I.R.C. § 6662 penalty for a substantial understatement for purposes of I.R.C. § 6662(b)(2) will apply.

An I.R.C. § 6662 penalty may apply also on the ground that the transaction constituted disregard of rules or regulations because it was a careless, reckless or intentional disregard of the provisions of the Code. I.R.C. § 6662(b)(1); I.R.C. § 6662(c).

An I.R.C. § 6662 penalty may apply also on the ground that the transaction gave rise to a substantial valuation misstatement under chapter 1 or a gross valuation misstatement. I.R.C. § 6662(b)(3); I.R.C. § 6662(e); I.R.C. § 6662(h). This is because the underlying adjustment could likely be viewed as an allocation of income pursuant to I.R.C. § 482. You may want to consider whether to use this theory for the underlying adjustment at least in the alternative because such determination would then be subject to an "abuse of discretion" standard of review.

We note that to the extent that the value of [redacted] equity exceeded what [redacted] paid for it, [redacted] received a constructive dividend from [redacted] (assuming that at that time [redacted] had earnings and profits pursuant to I.R.C. § 312) and made a gift to his son, [redacted]. [redacted] informed us that these adjustments have been pursued.

We note that I.R.C. § 1248 could apply if [redacted] had earnings and profits. [redacted] informed us that the transaction has been referred to an International Examiner. We thus have not considered this potential issue further and also have not considered whether any international transaction penalties would apply.

If we can be of further assistance with this case or you have any questions, please telephone [redacted] at [redacted].

Sincerely,

[redacted]
Associate District Counsel

By: /S/
[redacted]
Attorney